Fencing in the Regulated Utilities

Credit-rating linkage harms certain power companies. Ring-fencing is the best answer for regulators.

By Dr. Fred Grygiel and John Garvey

In recent years, a persistent battle has developed between state public utility commissions (PUCs) and holding companies over the negative financial and operational impacts on regulated utilities of failed diversification investments. Ratepayers expect to compensate companies for the costs of providing utility service—not those costs associated with the unregulated activities of affiliated companies.

Unfortunately, the realities are often painfully different, and in some instances disastrous for the financial health of the utility. Moreover, ratepayers and politicians are highly sensitive and easily outraged by a utility attempting to recover costs associated with non-regulated companies in the regulated cost of providing utility service.

Credit ratings linkage is an additional worry for state regulators when confronting failed diversification. Fitch and Standard & Poor's, for example, apply linkage in determining the ratings of companies within a holding company structure. This method directly links the credit rating of the utility to the parent and any affiliated companies. Consequently, the regulated utility may be penalized via a lower credit rating, which would not happen if it were a stand-alone company.

In fact, Fitch indicates that ratings linkages caused about half of all rating changes for electric and gas utilities. The consequences of linked credit ratings on utilities, of course, includes higher debt and equity costs that are typically passed along to ratepayers via higher charges for regulated services.

In reaction to the potential contamination of a utility's credit rating by a weaker parent or affiliate, PUCs recently have used various "ring-fencing" policy tools. The goal of a ring-fence is to insulate a utility from the risks of its holding company and affiliates. Depending on the efficacy of the ring-fence, a utility may be rated various notches higher than a weaker parent or affiliate. For example, the Oregon commission successfully ring-fenced Portland General Electric, which was acquired by Enron in 1997 and subsequently survived its parent's bankruptcy. While Enron's debt was downgraded to junk status, Portland General Electric's ratings were many notches higher as a result of the PUC's actions. It is important to note, however, that even with the implementation of strong ring-fencing policies, Portland General Electric did suffer somewhat from linkages when Enron filed for bankruptcy, including lack of access to the commercial paper market and below-investment grade unsecured debt.

However, many PUCs are not as proactive in ring-fencing utilities as the Oregon PUC was, and instead rely on *ex post* reactive measures. For example, many commissions do not act until the credit rating of the utility has been downgraded below investment grade. Similarly, many attempt to preclude recovery in rate cases of any incremental costs of capital that can be identified as attributable to a riskier parent or unregulated subsidiaries. While *ex post* measures may provide some relief to ratepayers, credit rating agencies usually require the implementation of *ex ante* or preventative ring-fencing policies before any rating de-linkage is considered. A proper *ex ante* framework would provide for both structural and operational ring-fencing.

Structurally, the utility should be viewed by its creditors and owners as a stand-alone company with a separate corporate identity and an appropriate capital structure *vis-á-vis* the parent. The utility should be, at the very least, a separate subsidiary, with its own accounting system, separate debt and preferred stock ratings, its own cash-management system, and operations financed separately from its parent. Optimally, a special-purpose entity or limited-purpose operating entity would be created that would achieve almost complete credit isolation and bankruptcy remoteness. Finally, the parent must guarantee that it will not include the utility in a petition for bankruptcy protection.

While structural ring-fencing is a necessary antecedent to effective insulation of a utility, it alone is insufficient unless coupled with operational ring-fencing policies. These policy tools are more of an administrative burden for PUCs because they require active oversight of: (1) affiliated transactions; (2) dividend policies; (3) securities issuances and financings; (4) ownership changes; (5) diversification investments; and (6) asset transfers.

The power of PUCs to provide the necessary operational ring-fencing varies significantly. The New Jersey Board of Public Utilities, for example, has expansive ring-fencing powers, while other PUCs do not. At the federal level, provisions in the Public Utility Holding Company Act (PUHCA) allow for various operational ring-fencing for companies under its purview. For example, PUHCA prevents cross-subsidization of non-regulated businesses by registered utilities. In addition, FERC policies prevent companies from borrowing money against utility assets to finance non-utility activities. FERC jurisdiction is limited, however. This operational oversight not only helps to protect the financial health of a utility, but it also helps to protect ratepayers by making cost-based regulation more accurate financially.

Most structural and operational ring-fencing mechanisms are derived from specific statutory powers granted to PUCs, although commissions lacking these may be able to impose ring-fencing under general regulatory powers via settlements in rate cases and mergers, for example. Irrespective, utility commissions should anticipate resistance from holding companies, particularly if the authority is derived from general powers instead of specific statutory language.

A careful legal analysis of existing powers to ring-fence should be initiated before embarking on such policies. Both Fitch and Regulatory Research Associates have recently completed major studies on ring-fencing that may provide some insight into what statutory and regulatory powers are needed for effective ring-fencing.

Moreover, if PUHCA is repealed, that would leave a gaping hole in the supervision of holding companies, so state legislative action may be necessary. At the federal level, there is growing support for an amendment to the Federal Power Act that would enable state and federal regulators to ring-fence utility subsidiaries.

In conclusion, ring-fencing holds out the prospect for insulating regulated utilities from the traditional failed diversification investments of the parent holding company. There always will be incentives for holding companies to seek out higher risk/return opportunities in related markets and industries. Absent a blanket prohibition of these activities and forced divestitures, holding companies will to varying degrees expose their regulated subsidiaries to potential harms from failed investments.

Successful ring-fencing is even more critical considering that state regulators are facing the challenges created by failures of corporate governance, accounting scandals, and in some cases alleged criminal conduct in energy markets. Ring-fencing may be the only regulatory device capable of leveling the playing field and forcing the holding companies to absorb the consequences of failed non-utility investments. F

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SNL Financial

MISO Transmission Owner System Data, 2003

Owner Name (All data in MWh)	Source		Transmission for Others		Use		
	Net Gen	Purchases	As Delivered	Net*	Retail Sales	Wholesale Sales	Total System Disposition**
Northern States Power Co. - Minn.	36,086,341	12,164,524	3,273,616	77,269	34,145,453	12,953,701	47,809,550
PSI Energy Inc.	34,270,141	6,223,981	3,783,755	-186,358	27,014,573	10,140,662	40,289,105
Cincinnati Gas & Electric Co.	26,937,620	5,769,785	4,366,450	4,057,907	20,590,342	14,774,924	36,761,761
Kentucky Utilities Co.	16,640,709	7,688,620	2,397,890	-4,051	17,593,563	5,591,070	24,342,886
Louisville Gas and Electric Co.	15,898,283	3,920,019	892,862	0	11,503,350	7,678,323	19,801,519
Interstate Power & Light Co.	13,313,386	4,503,104	1,782,792	41,492	15,503,520	1,298,495	17,859,056
Indianapolis Power & Light Co.	16,240,468	261,197	0	0	14,355,738	1,351,202	16,501,591
Wisconsin Power and Light Co.	10,506,927	4,651,891	0	0	10,034,852	4,400,160	15,158,818
Aquila Inc.	8,143,312	4,596,154	3,860,514	0	10,614,156	1,143,705	12,738,221
Minnesota Power Inc.	7,498,513	4,227,879	2,140,673	78,404	8,425,421	2,746,186	11,804,796
Southern Indiana Gas and Electric	6,507,481	4,082,404	0	0	5,297,928	4,906,114	10,755,592
Central Illinois Light Co.	5,670,222	5,023,908	315,454	0	9,573,886	662,509	10,694,130
Otter Tail Corp.	3,672,617	2,169,483	665,158	2,121,590	3,716,344	1,818,917	7,963,690
Northern States Power Co. - Wis.	1,189,310	5,738,565	0	0	5,861,256	566,589	6,927,875
Union Light, Heat and Power Co.	0	4,092,801	55,137	0	3,728,276	0	4,092,801
MDU Resources Group Inc.	2,384,884	920,171	1,202,846	91,020	2,359,888	841,637	3,368,719
Superior Water, Light & Power Co.	0	579,103	5,325	0	564,979	0	579,103
Northwestern Wisconsin Electric Co.	133	197,192	28,268	1,979	176,413	5,885	199,304

* Transmission for Others' reporting is inconsistent. Some filers include pass-through transactions involving customer-choice programs that result in a non-zero "Net" value. This creates a mix of data including traditional "wheeling" transactions, that typically net to zero, and other types of transactions. ** Total includes energy furnished without charge, energy for company use, and line losses.

This data represents publicly-available FERC Form 1 data only. As a result, seven public power and cooperative members and four transmission-only members are excluded.